Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term 1976

No. 76-248

REUBEN P. HUGHES,

Petitioner,

v.

DEMPSEY-TEGELER & CO., INC., a Delaware corporation, LEWIS WHITNEY and NEW YORK STOCK EXCHANGE, INC., a New York corporation,

Respondents.

RESPONDENT NEW YORK STOCK EXCHANGE'S BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI.

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Question Presented

May a fully informed investor, who conditioned his capital investment in a distressed brokerage firm on the lifting by a national securities exchange of its restrictions on the brokerage firm, recover his investment from the exchange on an implied cause of action under Section 6 of the Securities Exchange Act of 1934, 15 U.S.C. § 78f, where the brokerage firm subsequently fails and the exchange's asserted breach of duty is the very lifting of restrictions which the investor requested?

Statement of the Case

This is a petition for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit to review its decision filed on March 29, 1976, affirming the judgment of the United States District Court for the Central District

of California, entered on September 6, 1973, dismissing the action against all defendants on the merits after a fourteen day trial.

On March 24, 1970, Hughes entered into an agreement with respondent Dempsey-Tegeler & Co., Inc. ("Dempsey"), a brokerage firm and member organization of the Exchange, subordinating certain securities owned by Hughes to the creditors of Dempsey. Hughes was to receive, in addition to the normal earnings on those securities, annual interest of approximately $80,000. Subsequently, Dempsey was liquidated and Hughes' securities were sold for the benefit of Dempsey's creditors as provided in the subordination agreement.

The complaint, filed on May 28, 1971, sought recovery of $1,400,000 damages, or rescission of the subordination agreement, based on alleged violations of the Securities Act of 1933, the Securities Exchange Act of 1934, and the fraud sections of the California Civil Code. In essence, Hughes charged that respondent Whitney, president of Dempsey, and respondent Walraven, a vice president of Dempsey, misrepresented or failed to disclose facts concerning Dempsey's financial and operating condition, and that the Exchange failed to enforce its net capital and record-keeping rules and aided and abetted the wrongful conduct of the other respondents.

The District Court, in a thoughtful and detailed opinion, CCH Fed.Sec.L.Rep ¶ 94,133 (C.D. Cal. 1973)(A.*13), concluded that Hughes was not entitled to recover against any defendant under any possible theory of liability. The District Court found that Hughes was an exceptionally successful and experienced businessman who was counseled during his negotiations with Dempsey by his personal attorney. Hughes had had a 20-year relationship with Dempsey and had become a personal friend of Walraven and to a lesser extent Whitney. The District Court found that "Hughes

* "A" refers to the Appendix attached to the petition.

had *actual knowledge* of all the *material facts available* to a reasonably prudent investor," that "Hughes *intentionally* entered into the Dempsey subordination agreement with *full* knowledge of all his available rights," and had been told by Dempsey that "there was a 'good chance' that he would lose his money if he went ahead with the subordination." (A.78, 40) The District Court also found that the Exchange's regulation of Dempsey pursuant to its duty under Section 6 of the Exchange Act was not unreasonable, both in September 1969 when the Exchange determined to restrict Dempsey rather than to suspend it, and on March 24, 1970, when the Exchange lifted its restrictions, partly due to the fact that Hughes and John King, another wealthy investor, had agreed to subordinate securities to the creditors of Dempsey which increased Dempsey's net capital by approximately $8 million. The District Court further found that the Exchange's decision to lift its restrictions was "a good faith effort to do principally two things: (1) rescue Dempsey, and thereby protect its creditors; and (2) prevent a general market loss of confidence, and thereby protect other firms within its responsibility." (A. 62-63)

The Court of Appeals affirmed, agreeing that Hughes had full disclosure and that the Exchange had fulfilled its duty under Section 6 in September, 1969, when it imposed restrictions on Dempsey. The Court of Appeals disagreed, however, with the District Court's conclusion that the Exchange's decision to lift the restrictions on Dempsey in March, 1970 did not constitute a breach of the Exchange's Section 6 duty owed to Hughes. But the Court of Appeals went on to hold that Hughes was barred from recovery under the doctrine of waiver because Hughes had actual knowledge that the Exchange had imposed restrictions on Dempsey for the protection of the investing public, including himself, but Hughes nevertheless conditioned his loan on the lifting of the restrictions and even encouraged the lifting of the restrictions, and knew before he invested that the restrictions were to be lifted.

Petitioner contends that this Court should review the Court of Appeals' holding that Hughes' complete knowledge and encouragement to the Exchange to lift its restrictions bars Hughes from recovering against the Exchange. The petition seeks no relief against any defendant other than the Exchange; nor does it challenge the dismissal of Hughes' fraud claims against the Exchange.

Facts

During the last half of the 1960's, Dempsey suffered serious capital and operations difficulties resulting from the inability of its multiple accounting centers to keep pace with the rapid expansion of trading volume. The Exchange had levied sanctions of various types on Dempsey to obtain compliance with Exchange rules. When the Exchange received in September, 1969, the yearly audit of Dempsey by Haskins & Sells, serious operational and financial problems were apparent. A joint regulatory approach was worked out between the Exchange and the Securities Exchange Commission ("Commission"). The Exchange ordered Dempsey to retract its business so that it could be handled by one accounting center. Jerome Tegeler, president, was suspended by the Exchange for a year. The Exchange ordered Dempsey to close 50% of its branch offices and to prepare a schedule for the elimination of accounting and record-keeping problems reflected in its records. The Commission restricted Dempsey from participation in any future underwritings. Thereafter, both the Exchange and the Commission maintained close and coordinated surveillance of Dempsey. Subsequently, Robert Peck, a back office expert with considerable experience, was retained by Dempsey at the urging of the Exchange to serve as Dempsey's chief operations and financial officer.

By March, 1970, Dempsey was handling its current business on a daily and accurate basis. Aside from a deficiency under the Exchange's "net capital" rule, the problems of Dempsey were the carry-over problems re-

sulting from the poor management under Jerome Tegeler. While these problems required correction, they were not being added to by the daily transactions of the firm. The restrictions imposed on Dempsey by the Exchange had had their intended effect. By February 23, 1970, 33 of Dempsey's 66 branch offices had been closed. (Ex.* 3) Whitney and Peck had the firm on an efficient daily operating basis. By March 1, all accounting and operational control was centralized in Los Angeles. (Exs. 3 and 7) New York personnel were free to attack the past accounting problems. (Ex. 7) A complete house count of all securities was made as of February 20, 1970. (*id.*) Peck had submitted to the Exchange and the Commission a reasonable plan for restoring Dempsey to profitability and for clearing up the residual problems that had carried over from the Jerome Tegeler regime. (Ex. 3-8) On the basis of these facts, and the addition of the King and Hughes capital which Dempsey needed, the Exchange believed Dempsey had turned the corner and stood a good chance of becoming a profitable firm. (Tr.** 1653-54, 2601-02)

The reason that the Exchange lifted its restrictions, and the reason why King and Hughes insisted that it do so, was that Dempsey's then current operating losses were the result of the Exchange's restriction on hiring new registered representatives and the Commission's restriction on Dempsey's participating in underwritings. (Ex. 4) Dempsey, in short, needed to increase income to match fixed expenses. Neither King nor Hughes wished to invest in a firm that did not have the potential for profit. Peck's plan for restoring the firm to profitability required removal of the Exchange's restrictions and the Commission's restrictions, and there was no reason not to do so because Dempsey was handling its present business efficiently. At the same time the Exchange lifted its restrictions, the Commission lifted its own restrictions on Dempsey. (Tr. 1610-11)

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* "Ex." refers to the designated exhibit in the record below.

** "Tr." refers to the trial transcript in the record below.

As of March 24, 1970, all knowledgeable parties—the Exchange, the Commission, King (who had made a five-month intensive examination of Dempsey through accountants and lawyers), and Hughes—came to the conclusion that the program being followed by Dempsey to resolve its problems was appropriate and that, if the restrictions were lifted, the firm had a good chance to survive.

The Court of Appeals' disagreement with the District Court on the issue of whether the Exchange breached its Section 6 duty by lifting the restrictions in March was based on the Court of Appeals' view that "[t]he Exchange has presented nothing to support an argument that the restrictions were no longer necessary." (A. 125) This conclusion was error. The Exchange argued (Appellees' Brief pp. 71-73) to the Court of Appeals and the evidence showed that by March the restrictions had had their intended effect by reducing Dempsey's size to a manageable one and in generating a plan to clear up past errors. That was what the restrictions were designed to accomplish. If Dempsey were to survive, it had to restore itself to profitability and obtain more capital. Indeed, Judge Sneed's concurring opinion views Dempsey's possibility of acquiring the subordinated capital of King and Hughes in and of itself sufficient new circumstances to justify the reasonableness of the Exchange's lifting of the restrictions. (A. 134-35) Thus, the result below can be based on the District Court's finding that there was no breach of the Exchange's Section 6 duty, and for that reason alone the petition should be denied.

Unfortunately, Dempsey never obtained profitability after March 24, 1970 because of two sudden and unforeseeable events which were the proximate cause of Dempsey's demise. The District Court found (A. 42-43) that immediately after the King and Hughes subordinations, the entire stock market plummeted to an extent that the New York Stock Exchange Index declined by approximately 25% and the American Stock Exchange and over-the-counter averages declined by substantially greater amounts. This decline was accompanied by a sharp decrease in the volume of securities traded. The effect of the precipitous decline in the value of securities and trading volume was to erode the value of Dempsey's capital, chiefly securities, and to diminish its principal source of income from commissions on trading. Additionally, the roughly $7 million of Dempsey's net capital value reflected by the subordinated King stock eroded to practically nothing and King failed to fulfill his contractual agreement to supply additional collateral to keep his loan at a net capital value of $7 million. The District Court found (A. 43, 69-70) that both the decline in securities values and trading volume and the failure of King to fulfill his agreement were unforeseeable by the Exchange, and that Hughes had acknowledged that unforeseeability.

Reasons for Denying the Writ

I. The Decision Below Does Not Raise the Question of Whether Common Law Defenses Should be Permitted to Claims Based on Prohibitory Sections of the Securities Laws.

Petitioner argues that this court should review the decision below on the basis of lower court cases rejecting common law defenses to claims brought under other sections of the Exchange Act. *Pearlstein* v. *Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971) (Section 7) and *Woolf* v. *S. D. Cohn & Co.*, 521 F.2d 225 (5th Cir. 1975) (Section 10(b)). Petitioner also urges that review is supported by the Court's decision in *Permalife Muffler, Inc.* v. *International Parts Corp.*, 392 U.S. 134 (1968) (rejecting the *in pari delicto* defense to a claim under the antitrust laws). Neither *Pearlstein*, *Woolf* nor *Permalife* is apposite.

Sections 7, 15 U.S.C. § 78g, (excessive credit) and 10(b), 15 U.S.C. § 78j(b), (intentional fraud) declare certain conduct unlawful. The lower courts for some time have been dealing successfully with the issue of when and where common law defenses should preclude recovery based on implied causes of action under those and other prohibitory statutes. See,

e.g., *Serzysko* v. *Chase Manhattan Bank,* 290 F.Supp. 74 (S.D.N.Y. 1968), *aff'd mem.,* 409 F.2d 1360 (2d Cir.), *cert. denied,* 396 U.S. 904 (1969) (*in pari delicto* applied to bar claims under Section 7); *Malamphy* v. *Real-Tex Enterprises, Inc.,* 527 F.2d 978 (4th Cir. 1975) (*in pari delicto* defense applied to federal disclosure claims); *James* v. *Du Breuil,* 500 F.2d 155 (5th Cir. 1974) (unclean hands and *in pari delicto* applicable to Rule 10b-5 claims in the sound discretion of the district court); *Straley* v. *Universal Uranium and Milling Corp.,* 289 F.2d 370, 374 (9th Cir. 1961) (common law defenses normally available according to the exigencies of the particular case permitted against a claim under Section 12 of the Securities Act of 1933). Those cases cited by petitioner that have precluded common law defenses to claims under Sections 7 and 10(b) have done so on the theory that it is more important to discourage the conduct declared by Congress to be unlawful than to adjust the equities of a particular transaction.

Unlike prohibitory statutes such as Section 7 or Section 10(b) of the Exchange Act, or the antitrust laws, Section 6 does not declare any conduct unlawful. Section 6 directs securities exchanges to register with the Commission by submitting for the Commission's approval the exchange's rules and to agree to enforce compliance by the exchange's members "so far as is within its powers."* Lower courts have implied a duty on the part of exchanges to enforce their rules. However, as this Court recognized in *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware,* 414 U.S. 117, 127 (1973):

> "The Securities Exchange Act of 1934, as amended, 15 U.S.C. §§ 78a to 78hh-1, 'regulates securities markets and the business of securities brokers and dealers.' Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, pt. 1, 88th Cong., 1st Sess., 3 (1963). Two types of regulation are reflected in the Act. Some provisions impose direct requirements and prohibitions. Among these are mandatory exchange registration, restrictions on broker and dealer borrowing, and the prohibition of manipulative or deceptive practices. Other provisions are flexible and rely on the technique of self-regulation to achieve their objectives. *Ibid.* Supervised self-regulation, although consonant with the traditional private governance of exchanges, allows the Government to monitor exchange business in the public interest." (footnote omitted)

* The requirement of an agreement to enforce compliance has been deleted from Section 6 by the Securities Reform Act of 1975.

It is clear that an exchange's duty of self-regulation of its members under Section 6 is among the second type of regulation and the prohibitory statutes such as Sections 7 and 10(b) are among the former. All lower courts that have considered the question, including the two courts below, agree that the direction to enforce rules calls for the exercise of judgment as to the way in which compliance is obtained. Here the breach of duty under Section 6 is the result of a reviewing court's disagreeing with the reasonableness of an exchange's judgment, not the commission of an act (lifting restrictions) which Congress has declared unlawful.

If this Court wishes to review the issue of whether common law defenses might preclude recovery on an implied cause of action for the commission of an act declared by Congress to be unlawful, the Court should select a case arising under Section 7, 10(b) or other statute of that type. The decision below, however, is the only decision to consider a defense to a Section 6 claim. There is, therefore, no conflict, no confusion, and no need for this Court's guidance on any issue raised by the decision below. Furthermore, the Exchange is unaware of any other case in which the issue presented by this petition has been or will be raised.

II. The Decision Below Does Not Encourage Exchanges to Breach their Section 6 Duty.

Section 6 of the Exchange Act requires registered national securities exchanges to enact rules and to enforce those rules in respect to members of the exchange. Congress left to the Commission the job of supervising exchanges. See Sections 6 and 19 (78 U.S.C. § 78s) of the Exchange Act; *Merrill Lynch, Pierce, Fenner & Smith* v. *Ware, supra; Gordon* v. *New York Stock Exchange, Inc.*, 498 F.2d 1303, 1306, *aff'd*, 422 U.S. 659 (1975). The lower courts, starting with *Baird* v. *Franklin*, 141 F.2d 238, *cert. denied*, 328 U.S. 737 (1944), have implied a private cause of action against exchanges for breach of a Section 6 duty. Both the District Court and the Court of Appeals agreed that the exchanges are to be accorded discretion and flexibility in interpreting and enforcing their rules. (A. 71, 110-11, 114-17) Here, the Exchange identified Dempsey's rule violations and put into effect, coordinately with the Commission, a program of regulation designed to correct the problems and obtain compliance with the Exchange's rules. The Exchange, the Commission, the District court and one judge on the Court of Appeals (A. 133-36) concluded that the lifting of the restrictions in March was not a breach of the Exchange's Section 6 duty because it was not unreasonable. The Court of Appeals disagreed but then precluded Hughes from recovering because of his knowledge and encouragement of the lifting of the restrictions.

The Court of Appeals' decision can in no way inhibit the Exchange or any other exchange from the good faith exercise of its discretion to obtain compliance with its rules. Petitioner is wrong when he characterizes (Pet. 9) the breach of duty which the Court of Appeals found to be a "knowing breach." The Exchange did not know it committed a breach until the Court of Appeals said so. The District Court found the Exchange at all times acted in good faith and the Court of Appeals agreed. (A. 62-63)

The Court of Appeals specifically rejected the Exchange's

argument that a negotiated waiver by Hughes was sufficient to absolve the Exchange of responsibility. (A. 126, n. 13) Having done that, only full knowledge and encouragement by future plaintiffs can, on the rationale of the Court of Appeals, preclude recovery by a particular plaintiff against an exchange for breach of Section 6. That knowledge and encouragement are peculiarly outside of the control of the exchanges and cannot influence them to refrain from enforcing their rules.

On the other hand, had the decision below afforded Hughes recovery against the Exchange, that decision would discourage national securities exchanges from the flexible and creative exercise of their judgment to protect public investors. The aim of the self-regulatory scheme of the Exchange Act is "the protection of investors". (See Exchange Act, Sections 6(a), 6(d) and 19(b)) As the District Court found (A. 71), this mandate includes important obligations, "both legal *and* ethical," to other members of the Exchange and their clients (the investing public). The lifting of the restrictions on Dempsey and injection of the King and Hughes capital into Dempsey were accomplished with the good faith aim of giving Dempsey a chance to survive and of protecting Dempsey's customers, the customers of other firms, and the general economy. To force the Exchange to reimburse Hughes for the risk he knowingly undertook will discourage national securities exchanges from sound regulation in favor of inflexible enforcement of their rules. In the next case, were Hughes to have been awarded recovery on these facts, the investing public, the especial beneficiaries of Section 6, would be at far greater risk.

III. The Decision Below Does Not Conflict with Section 29 of the Exchange Act.

Petitioner contends that the decision below is contrary to Section 29 of the Exchange Act, 15 U.S.C. § 78cc, because it gives effect to an oral waiver obtained during negotiations.

Petitioner misses the import of the Court of Appeals' rationale.

Section 29(a) of the Exchange Act declares void any "condition, stipulation, or provision binding any person to waive compliance" with the act or any rule thereunder. The decision below enforces no such "condition, stipulation or provision." The decision below, rather, found the legal effect of Hughes' knowledge and conduct to be that he waived any right he may have had to recover against the Exchange under an implied cause of action under Section 6. Such a waiver is in no way proscribed by Section 29(a) of the Exchange Act and is consistent with the common sense proposition stated by the Court of Appeals that:

> "The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and waits to see how his investment turns out before he decides to invoke the provisions of the Act." (A. 128, quoting from *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210, 213-14 (9th Cir. 1962)).

Conclusion

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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